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Proposed statement on auditing standards : The auditor's responsibility for assessing control risk ;Auditor's responsibility for assessing control risk; Exposure draft (American Institute of Certified Public Accountants), 1987, Feb. 14

American Institute of Certified Public Accountants. Auditing Standards Board

EXPOSURE DRAFT

PROPOSED STATEMENT ON AUDITING STANDARDS

THE AUDITOR'S RESPONSIBILITY FOR ASSESSING CONTROL RISK

FEBRUARY 14, 1987

Prepared by the AICPA Auditing Standards Board
For comment from persons interested in auditing and reporting

Comments should be received by July 15, 1987, and addressed to
AICPA Auditing Standards Division, File 3045
1211 Avenue of the Americas, New York, N.Y. 10036-8775

SUMMARY

Why Issued

This Statement was issued —

- To emphasize the importance of internal control to audit planning by broadening the auditor's responsibility to study and evaluate internal control when planning an audit.
- To clarify and bring up to date the guidance on the auditor's study and evaluation of internal control by incorporating the concepts concerning audit evidence and audit risk that have evolved in practice and that have been established in auditing standards issued subsequent to the issuance of AU section 320, *The Auditor's Study and Evaluation of Internal Control* (AICPA, *Professional Standards*, vol. 1).

What It Does

This Statement supersedes AU section 320. It describes the elements of a control structure and explains the auditor's responsibility for understanding the control structure and assessing control risk.

Specifically, the Statement —

- Describes an entity's control structure in terms of three elements — (1) control environment, (2) accounting system, and (3) control procedures.
- Requires the auditor to obtain an understanding of each control structure element sufficient to plan an audit, and —
  - (*a*) Describes the factors the auditor considers in determining the extent of understanding of the control structure that is necessary.
  - (*b*) Provides guidance about the auditing procedures to obtain that understanding.
- Explains the relationship of the understanding of the control structure to assessing control risk for financial statement assertions.
- Describes the factors the auditor considers in deciding whether to extend control risk assessment beyond the understanding of the control structure and provides guidance on the support necessary for such an assessment.
- Explains the relationship between the control risk assessment and detection risk for financial statement assertions.

This exposure draft has been sent to—

- *Practice offices of CPA firms.*
- *Members of AICPA Council and technical committees.*
- *State society and chapter presidents, directors, and committee chairmen.*
- *Organizations concerned with regulatory, supervisory, or other public disclosure of financial activities.*
- *Persons who have requested copies.*

How It Differs From Existing Standards

This Statement—

- Replaces the concept of internal control in AU section 320 with a broader concept of control structure that consists of the control environment, accounting system, and specific control procedures.
- Requires the auditor to understand the control structure to the extent necessary to plan the audit. AU section 320 does not contain such a requirement.
- Discusses the auditor's responsibility concerning the control structure in terms of control risk as defined in SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, and financial statement assertions as defined in SAS No. 31, *Evidential Matter.*
- Recognizes that an auditor may use information about an entity's control structure obtained in prior examinations in determining the scope of control structure work necessary for the current examination.
- Recognizes that an auditor's conclusion about the level of control risk for some financial statement assertions may preclude the need for tests of financial statement balances.
- Clarifies and updates terminology. (See box.)

Proposed Statement Terminology	*Related AU Section 320 Terminology*
Control Structure	Internal Control System
Assessing Control Risk	Study and Evaluation of Internal Control
Control-Risk-Assessment Procedures	Review of System and Compliance Tests
Tests of Financial Statement Balances	Substantive Tests
Conclusion about the Level of Control Risk/Assessment of Control Risk	Reliance on Internal Control
Control Structure Elements Relevant to Financial Statement Assertions	Accounting Controls and Administrative Controls

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IN ACCOUNTING
1887 1987

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February 14, 1987

Accompanying this letter is an exposure draft of a proposed statement on auditing standards titled The Auditor's Responsibility for Assessing Control Risk. A flowchart of the major steps in assessing control risk follows this letter. This exposure draft would supersede AU section 320, The Auditor's Study and Evaluation of Internal Control (AICPA, Professional Standards, vol. 1).

This Statement is being proposed to broaden and clarify the auditor's responsibility to study and evaluate internal control in planning an examination of financial statements. This broadening and clarification is necessary for two major reasons: first, to recognize the importance of internal control to the appropriate consideration of a number of audit planning matters that are not addressed in AU section 320; and second, to incorporate into professional standards on internal control several auditing concepts that have evolved in practice or that have been articulated in statements on auditing standards subsequent to the issuance of AU section 320.

AU section 320 has developed on a piecemeal basis over the last thirty-five years. It is a combination of three statements on auditing procedure issued between 1949 and 1972 that was then amended by eight statements on auditing standards (SASs). Concurrently, several other SASs have been issued that have either introduced or altered major auditing concepts that have not been incorporated into AU section 320. The combination of these two factors has created ambiguity in the professional standards pertaining to the study and evaluation of internal control and has left many elements of those standards incongruous with current auditing concepts and terms.

This proposed Statement replaces the concept of internal control in AU section 320 with a broader concept of control structure. The control structure consists of three elements—(1) control environment, (2) accounting system, and (3) control procedures. The control structure concept recognizes that components of each of these three elements may be relevant to an entity's ability to record, process, summarize, and report financial data consistent with management's assertions in the financial statements. Consequently, they each provide a form of control that may be relevant in an audit. This concept precludes the need for the artificial and sometimes confusing distinction between administrative and accounting controls used in AU section 320 to identify controls relevant in an audit.

AU section 320 also discusses the control environment, accounting system, and control procedures. However, that section provides only limited guidance about the nature of the control environment and accounting system and why the auditor considers them and includes only control procedures within the concept of internal control. The proposed Statement unifies these three elements into a single concept and provides an expanded discussion of the characteristics of each of them.

The proposed Statement requires the auditor to obtain an understanding of each of the three elements of the control structure sufficient to plan the examination. This requirement is based on the importance of an understanding of the control structure to audit planning considerations such as the following: auditability of financial statements; causes of potential material misstatements in financial statements and the risk such misstatements will occur; design of tests of financial statement balances; and determination of the appropriate detection risk for financial statement assertions. The proposed Statement provides guidance to the auditor in determining the extent of understanding of each element that is necessary for audit planning as well as the procedures to perform to obtain that understanding.

AU section 320 contains a more limited requirement concerning the auditor's responsibility to obtain an understanding of the control environment, accounting system, and control procedures for audit planning. It requires the auditor to obtain a general knowledge of the control environment and accounting system as a basis for determining whether there are control procedures that may be relied on or to aid the auditor in designing substantive tests in the absence of reliance. AU section 320 does not require the auditor to obtain an understanding of the control environment or accounting system for other audit planning purposes, nor does it require any understanding of control procedures for audit planning purposes unless the auditor intends to rely on control procedures.

The proposed Statement also discusses the control structure in relation to the auditor's responsibility for assessing control risk for financial statement assertions. This responsibility is similar but not identical to the responsibility discussed in AU section 320 concerning the study and evaluation of internal control to determine if there is a basis for reliance on controls. These responsibilities are similar in that they both concern the general concept of considering the effectiveness of an entity's controls in planning audit procedures to detect misstatements in the financial statements. The responsibilities differ, however, in that AU section 320 does not address either the concept of control risk or the concept of financial statement assertions.

SAS No. 47, Audit Risk and Materiality in Conducting an Audit, defined control risk and established the auditor's basic responsibility for assessing it. The proposed Statement replaces the concept of a study and evaluation of internal control in AU section 320 with the SAS No. 47 concept of assessing control risk. AU section 320 does not require an auditor to study and evaluate specific internal controls to determine whether they can be relied on. Similarly, the proposed Statement does not require an auditor to assess control risk for control structure elements specifically to determine if that risk is less than the maximum. It does, however, require the auditor to consider the extent of understanding of control structure elements that is necessary for audit planning. That understanding may provide a basis for the auditor to conclude that control risk is limited for some financial statement assertions.

The proposed Statement also indicates that the auditor assesses control risk for the financial statement assertions discussed in SAS No. 31, Evidential Matter. Such an assessment provides a basis for integrating the guidance in SAS No. 31 with the auditor's consideration of control risk.

As a result of incorporating the audit risk and assertion concepts in the proposed Statement, some new terms have been introduced and some terms that are in AU section 320 are no longer used. Most of the terms used in the proposed Statement have been defined either in other SASs or in the proposed Statement. Those terms that have not been explicitly defined are summarized below.

- Control-Risk-Assessment Procedures—These are procedures the auditor performs to obtain support for the assessment of control risk. They are used to determine whether the control structure policies and procedures relevant to a financial statement assertion (1) are suitably designed to prevent or detect and correct material misstatements in that assertion and (2) are operating in a manner that supports the auditor's assessment of control risk. Examples of these procedures are discussed in paragraph 38 of the proposed Statement. AU section 320 refers to similar procedures as a review of the system and compliance tests and discusses examples of them in paragraph 56 and paragraphs 64 through 67.
- Tests of Financial Statement Balances—These are procedures performed to detect misstatements in financial statements. They are used to restrict detection risk, as defined in SAS No. 47, to the desired level. Such tests may be categorized in two general classes: (1) tests of details of transactions and balances and (2) analytical procedures applied to financial information. These tests are discussed in paragraph 45 of the proposed Statement. AU section 320 refers to similar tests as substantive tests and discusses examples of them in paragraph 79.

Comments or suggestions on any aspect of this exposure draft will be appreciated. The Auditing Standards Board's consideration of responses will be helped if the comments refer to specific paragraphs and include supporting reasons for each suggestion or comment.

In developing guidance, the Auditing Standards Board considers the relationship between the cost imposed and the benefits reasonably expected to be derived from audits. It also considers differences that the auditor may encounter in the audit of the financial statements of small businesses and, when appropriate, makes special provisions to meet those needs. Thus, the board would particularly appreciate comments on those matters.

Written comments on the exposure draft will become part of the public record of the Auditing Standards Division and will be available for public inspection at the offices of the AICPA after August 17, 1987, for one year. Responses should be sent to the AICPA Auditing Standards Division, File 3045, in time to be received by July 15, 1987. For convenience in responding, a perforated response form is attached and a postpaid return envelope is provided with this exposure draft.

Sincerely,

Jerry D. Sullivan

Jerry D. Sullivan
Chairman
Auditing Standards Board

Dan M. Guy

Dan M. Guy
Vice President, Auditing

Flowchart
Process of Assessing Control Risk

Obtain understanding of control structure sufficient to plan audit (paragraphs 18-30). Necessary in all audits to help auditor—

- Identify conditions that may affect auditability, causes and risks of misstatements, and design of other audit tests.
- Make preliminary control risk assessment.
- Decide whether additional control risk assessment would be effective and efficient.

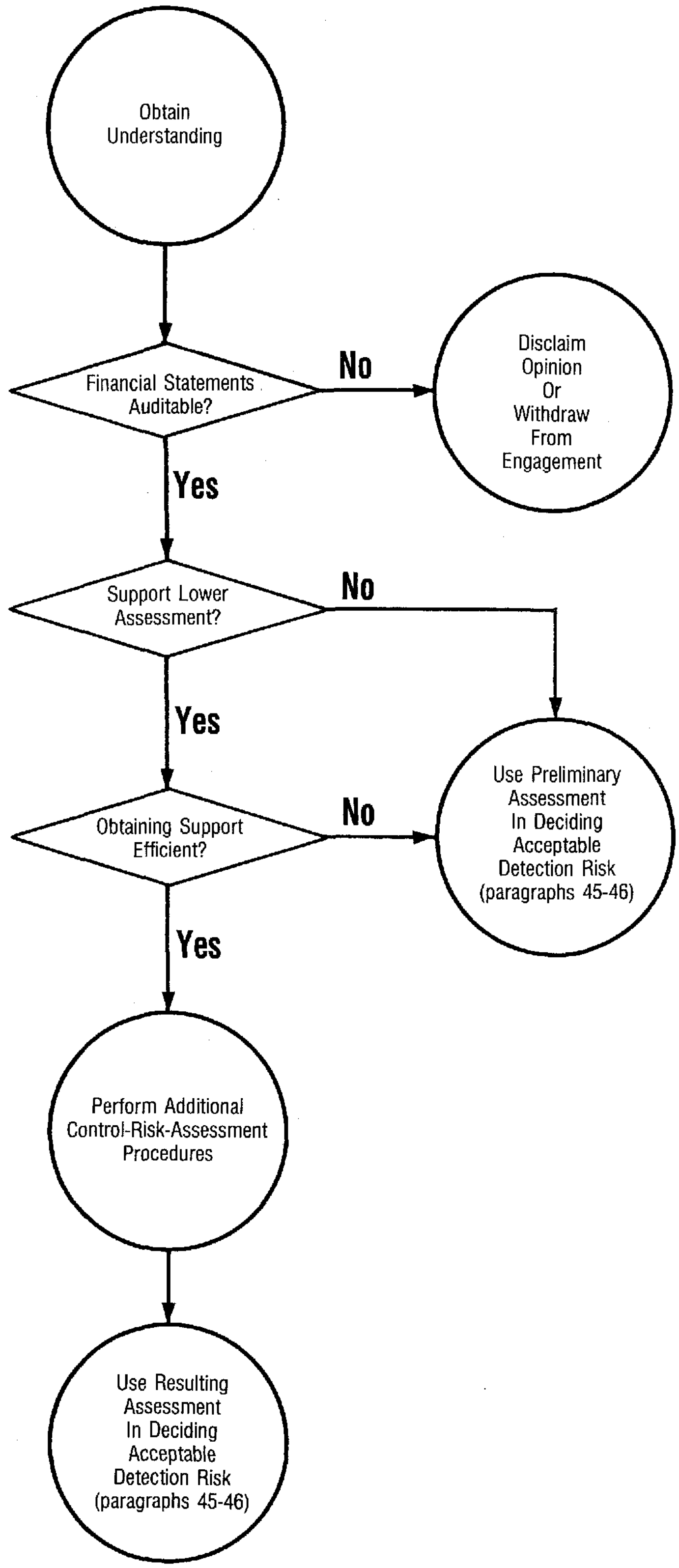
Does understanding indicate that financial statements are not auditable?

Is it likely support could be obtained for control risk assessment lower than preliminary for some assertions? (paragraphs 31-33)

Is it likely to improve audit efficiency to obtain such support? (paragraphs 34-36)

Perform additional control-risk-assessment procedures and assess level of control risk they support for those assertions (paragraphs 37-44)

Use resulting assessment of level of control risk when deciding the acceptable detection risk for those assertions (paragraphs 45-46)



PROPOSED STATEMENT ON AUDITING STANDARDS

THE AUDITOR'S RESPONSIBILITY FOR ASSESSING CONTROL RISK

(Supersedes AU section 320, *The Auditor's Study and Evaluation of Internal Control*, AICPA, *Professional Standards*, vol. 1)[1]

1. This Statement provides guidance on the independent auditor's responsibility to assess control risk in an examination of financial statements performed in accordance with generally accepted auditing standards. It describes the elements of a control structure and how the auditor considers them in assessing control risk. This Statement also explains how the auditor's assessment of control risk affects audit planning.

CONTROL RISK

2. Control risk is the risk that misstatements that could occur in an account balance or class of transactions and that could be material, when aggregated with misstatements in other balances or classes, will not be prevented or detected and corrected on a timely basis by an entity's control structure.

ELEMENTS OF A CONTROL STRUCTURE

3. An entity's control structure consists of the policies and procedures established to provide reasonable assurance that its established objectives will be achieved. The control structure may include a wide variety of objectives and related policies and procedures, only some of which may be relevant to an examination of its financial statements. Generally, the relevant policies and procedures are those that pertain to the entity's ability to record, process, summarize, and report financial data consistent with management's assertions embodied in the financial statements.[2]

4. To determine which policies and procedures are relevant to an examination of financial statements, the auditor identifies those that may be effective in preventing or detecting and correcting material misstatements in the entity's financial statements.[3] For purposes of an examination of financial statements, an entity's control structure consists of three elements—(*a*) the control environment, (*b*) the accounting system, and (*c*) control procedures.

Control Environment

5. The control environment consists of the overall attitude, awareness, and actions of the board of directors, management, owners, or others with similar authority concerning the matters discussed in paragraphs 6 through 12. The attitude, awareness, and actions are indicators of the philosophy of the board of directors, management, and owners about the importance of control and the emphasis it is given in the entity.

6. *Management Philosophy and Operating Style.* Management philosophy and operating style encompass a broad range of characteristics. Such characteristics may include the following: management's attitudes and actions toward financial reporting and taking business risks; management's emphasis on meeting budget, profit, and other financial and nonfinancial goals; management's preference for centralized or decentralized management; and the extent to which management is dominated by one or a few individuals. These characteristics have a significant influence on the control environment, regardless of the consideration given to the other control environment factors.

7. *Organizational Structure.* An entity's organizational structure provides the overall framework for planning, directing, and controlling operations. An effective organizational structure includes appropriate consideration of the form and nature of an entity's organizational units, the data processing organization, and related management functions and reporting relationships. In addition, the organizational structure should assign authority and responsibility within the entity in an appropriate manner.

8. *Audit Committee.* An effective audit committee, or its equivalent, takes an active role in overseeing an entity's accounting and financial reporting policies and practices. The committee should assist management and the board of directors in fulfilling their fiduciary and accountability responsibilities, and should help maintain a direct line of communication between the board and the entity's external and internal auditors.

9. *Methods to Communicate the Assignment of Authority and Responsibility.* These methods affect the understanding of reporting relationships and responsibilities established within the entity. Effective methods to communicate assigned authority and responsibility include appropriate consideration of—

- Assignment of responsibility and delegation of authority to deal with such matters as organizational goals and objectives, operating functions, and regulatory requirements.
- Employee job descriptions delineating specific duties, reporting relationships, and constraints.
- Entity policy regarding such matters as acceptable business practices, conflicts of interest, and codes of conduct.

[1] Other editorial changes will be made to Statements on Auditing Standards to incorporate the terms in this pronouncement.

[2] The term "financial statement assertions" is used throughout this Statement to refer to the five categories of management's assertions that are embodied in the account balance, class of transaction, and disclosure components of financial statements as discussed in paragraphs 3 through 8 of Statement on Auditing Standards No. 31, *Evidential Matter.*

[3] For purposes of this Statement, the term "misstatements" means errors and irregularities as they are defined in the proposed SAS, *The Auditor's Responsibility to Detect and Report Errors and Irregularities.* That proposed Statement defines "errors" as unintentional misstatements or omissions in financial statements and "irregularities" as intentional misstatements in financial statements.

10. *Management Control Methods.* These methods affect management's direct control over the exercise of authority delegated to others and its ability to effectively supervise overall company activities. Effective management control methods include appropriate consideration to—

- Establishing planning and reporting systems that set forth management's plans and the results of actual performance. Such systems include strategic business planning; budgeting, forecasting, and profit planning; and responsibility accounting.
- Establishing methods that identify the status of actual performance and exceptions from planned performance, as well as communicating them to the appropriate levels of management.
- Using such methods at appropriate management levels to investigate variances and take appropriate and timely corrective action.
- Establishing and monitoring policies for developing and modifying accounting systems and control procedures, including the development, modification, and use of any related computer programs and data files.
- Establishing an internal audit function with qualified personnel and with appropriate authority and reporting relationships.

11. *Personnel Management Methods.* These methods affect an entity's ability to employ sufficient competent personnel to accomplish its goals and objectives. Effective personnel management methods include appropriate consideration of an entity's policies and procedures for hiring, training, evaluating, promoting, and compensating employees, and giving them the resources necessary to discharge their assigned responsibilities.

12. *External Controls Over an Entity.* These are controls established and exercised by parties outside an entity that affect an entity's operations and practices. They include monitoring and compliance requirements imposed by legislative and regulatory bodies, such as audits by bank regulatory agencies. They also include careful review and follow-up by parties outside the entity concerning entity actions. Establishing and exercising external controls ordinarily is outside an entity's authority; such controls, however, may heighten management's consciousness of and attitude toward the conduct and reporting of an entity's operations.

13. The control environment factors discussed in paragraphs 6 through 12 are not necessarily relevant or equally significant to all entities. The applicability and importance of each factor should be considered in the context of the following: (*a*) a particular entity's size, (*b*) the nature and complexity of its operations, (*c*) its ownership characteristics, and (*d*) the ability of its management to take action concerning each factor. For a small, closely held company, some of the control environment factors may not be relevant or may be less significant than they would be for a large public company. For example, a formal, written code of conduct may be significant to the control environment of a large entity, but a small entity with effective owner-manager involvement may not need a formal code. Similarly, some entities need an organizational structure that provides for formal delegation of authority, whereas others do not.

Accounting System

14. The accounting system consists of the methods and records established to identify, assemble, classify, analyze, record, and report an entity's transactions and to maintain accountability for the related assets. An effective accounting system includes appropriate consideration to establishing methods and records that will—

- Identify and record all valid transactions.
- Describe on a timely basis the type of transaction in sufficient detail to permit proper classification of the transaction for financial reporting.
- Measure the value of the transaction in a manner that permits recording its monetary value in the financial statements.
- Determine the time period in which the transaction occurred to permit recording of the transaction in the proper accounting period.
- Present properly the transaction and related disclosures in the financial statements.

15. The types and detail of the methods and records that constitute an entity's accounting system will be significantly influenced by the following: the entity's size, complexity, and ownership characteristics; the nature of its business; its use of computers; and whether the entity is subject to the jurisdiction of regulatory agencies. For example, a small entity with effective owner-manager involvement may not need purchase requisitions, sales orders, or receiving reports. Similarly, small entities may not need subsidiary ledgers for specific classes of transactions such as sales, purchases, or cash receipts and disbursements.

Control Procedures

16. Control procedures are those policies and procedures in addition to the control environment and accounting system that management has established to provide reasonable assurance that an entity's established objectives will be achieved. Control procedures have various objectives and are applied at various organizational and data processing levels. Generally, they may be categorized as procedures pertaining to—

- Proper authorization of transactions and activities such as general or specific approval of transactions and approval for the reentry of transactions rejected by the computer.
- Adequate segregation of duties, such as separating the responsibility for custody of assets from the responsibility for the related record-keeping, and separating computer programming from computer operations.
- Adequate documents and records, such as prenumbered documents.
- Adequate safeguards over access to and use of assets and records, such as secured facilities.

- Independent checks on performance, such as clerical checks, reconciliations, computer-programmed edit controls, management review of reports that summarize the detail of account balances, such as an aged trial balance of accounts receivable, and user review of computer-generated reports.

17. The specific control procedures that an entity establishes are influenced by its size, complexity, and ownership characteristics, as well as by the nature of its business, its control environment, its accounting system, and its method of data processing. For example, a large public entity may establish formal approved vendor or customer lists, a formal credit policy, competitive bid procedures, or an imprest payroll bank account. For a small, closely held company, however, such control procedures may not be necessary.

UNDERSTANDING THE CONTROL STRUCTURE AND PLANNING THE AUDIT

18. In all examinations, the auditor should obtain an understanding of each of the three elements of the entity's control structure sufficient to plan an examination of the entity's financial statements. An entity's control structure affects the auditor's consideration of the following planning matters: the auditability of the entity's financial statements, the causes of potential material misstatements that could occur in its financial statement assertions, the risk that material misstatements will occur, the design of tests of financial statement balances, and the appropriate level of detection risk for financial statement assertions.

Relationship of Control Structure to Audit Planning

19. The auditability of financial statements depends on the availability of sufficient competent evidential matter to support an opinion on the financial statements. This availability may be affected by such matters as the integrity of the entity's management or the nature and extent of the records that the entity maintains. The auditor's understanding of the control structure may disclose conditions that influence the auditor's judgment concerning these and other matters that affect auditability.

20. An understanding of the control structure is one source of information about potential causes of possible material misstatements, including management misrepresentations, that could occur in financial statement assertions. This understanding also may identify factors that influence the risk that such misstatements will occur. Such information may either heighten or mitigate the auditor's concern about both the potential causes of material misstatements and the risk that they will occur.

21. The auditor's understanding of the control structure also provides information about the specific policies, procedures, methods, records, and reports pertaining to the control-structure elements. Knowledge of these matters influences the auditor's design of tests of financial statement balances. For example, such knowledge may assist the auditor in deciding whether to use analytical procedures or tests of details for a particular audit objective or in deciding whether to use computer-assisted audit techniques.

22. The auditor's understanding of the control structure also provides information that he considers in making an assessment of control risk. The auditor's assessment of control risk influences the detection risk that he is willing to accept for specific financial statement assertions. This assessment involves (*a*) identifying the control structure policies and procedures that pertain to a specific audit objective for a specific assertion and (*b*) evaluating the effectiveness of those policies and procedures in achieving or contributing to the achievement of the audit objective.

Extent of Understanding

23. The extent of understanding of each of the three control structure elements that is necessary to plan an examination and the procedures performed to obtain that understanding will vary with the size and complexity of the entity and the auditor's experience with the entity.

24. The auditor should obtain an understanding of the control environment sufficient to assess management's and the directors' attitude, awareness, and actions concerning the control environment factors discussed in paragraphs 6 through 12. In evaluating management's consideration of the control environment factors, the auditor should concentrate on the substance of management's policies, procedures, and related actions rather than their form. Management may establish appropriate policies and procedures but not act on them. For example, a budgetary reporting system may provide adequate reports, but the reports may not be analyzed and acted on. Similarly, management may establish a formal code of conduct but act in a manner that condones violations of that code.

25. The auditor's understanding of the accounting system ordinarily should include—

- The major classes of transactions in the entity's operations.
- How those transactions are initiated.
- The accounting records, supporting documents, machine-readable information, and specific accounts in the financial statements involved in the processing and reporting of transactions.
- The accounting processing involved from the initiation of a transaction to its inclusion in the financial statements, including how the computer is used to process data.
- The financial reporting process used to prepare the entity's financial statements, including the preparation of significant accruals, deferrals, and disclosures.

26. The understanding of an entity's control procedures that is appropriate for audit planning depends on the auditor's judgment about how extensive an understanding is necessary (*a*) to identify causes

of potential material misstatements in the financial statements and (*b*) to design effective tests of financial statement balances. Ordinarily, an understanding of all of an entity's control procedures is not necessary for audit planning.

27. In making a judgment about the first factor—causes of potential material misstatements—the auditor recognizes that proper audit planning requires consideration of significant sources of potential material misstatements, including conditions that significantly impair the entity's ability to record, process, summarize, and report financial data consistent with financial statement assertions. Consequently, the auditor considers the extent of knowledge obtained from other sources about the potential causes of possible material misstatements when determining the extent of understanding of control procedures that is necessary.

28. In making a judgment about the second factor—designing effective tests of financial statement balances—the auditor considers the complexity and sophistication of the entity's operations and systems, including whether the method of controlling data processing is based on manual procedures independent of the computer or is highly dependent on computerized controls. The auditor should recognize that as an entity's operations and systems become more complex and sophisticated, it may be necessary to devote more attention to control procedures to obtain the understanding of them that is necessary to design effective tests of financial statement balances.

Procedures to Obtain Understanding

29. The auditor should perform procedures to obtain an understanding of the entity's control structure. These procedures should be sufficient to provide knowledge about (*a*) the design of the policies, procedures, methods, and records pertaining to each control structure element and (*b*) whether they have been placed in operation. The auditor's understanding of the design of the policies, procedures, methods, and records ordinarily is obtained through the following: previous experience with the entity; inquiries of appropriate management, supervisory, and staff personnel; inspection of entity documents and records; and observation of entity activities and operations. For example, in obtaining an understanding of the nature and design of the accounting system, the auditor's prior experience with the entity may provide an understanding of its major classes of transactions, while inquiries of appropriate entity personnel and inspection of documents and records such as source documents, journals, and ledgers may provide an understanding of the accounting records and documents involved in the processing of those transactions.

30. The auditor's understanding of whether the policies, procedures, methods, and records have been placed in operation ordinarily is obtained by following one or a few applications of a particular policy, procedure, or transaction and observing the related actions and documents involved. For example, in acquiring an understanding of whether accounting system procedures and documents have been placed in operation, the auditor may follow the processing of one or of a few specific transactions, observing the documents and records used and the actions taken during such processing.

ASSESSING CONTROL RISK

31. The results of the procedures the auditor performs to obtain an understanding of an entity's control structure provide a basis for a preliminary assessment of the level of control risk for financial statement assertions. For some assertions, this preliminary assessment may be that control risk is limited; for other assertions, this assessment may be that control risk is not limited.

32. The auditor may conclude that for some assertions it is unlikely that he could support an assessment of control risk that is lower than his preliminary assessment. In such circumstances, he uses the preliminary assessment of control risk when determining the appropriate detection risk to accept for those assertions.

33. For other assertions, the auditor may believe that he can obtain support for an assessment of control risk that is lower than the preliminary assessment. Consideration of the results of the procedures performed to obtain the understanding of the control structure, as well as pertinent information from other sources, allows the auditor to form an expectation about the assessment of control risk that he could support if he extended his control-risk-assessment procedures. In such circumstances, the auditor considers whether audit efficiency is likely to be improved if control-risk-assessment procedures are extended to obtain that support.

34. In making that consideration, the auditor recognizes that additional audit effort will be necessary to obtain support for a lower assessment of control risk. However, the auditor also recognizes that a lower assessment of control risk would result in less audit effort for the tests of financial statement balances for those assertions. Consequently, the auditor weighs the increase in audit effort associated with extending his control-risk-assessment procedures to support a lower assessment of control risk against the decrease in audit effort associated with the reduced tests of financial statement balances that would result from such an assessment.

35. For some assertions, the auditor may conclude that it would not be efficient to extend his control-risk-assessment procedures to support a lower assessment of control risk. In such circumstances, the auditor uses the preliminary assessment of control risk when determining the appropriate detection risk to accept for those assertions.

36. For other assertions, the auditor may conclude that it would be efficient to extend his control-risk-assessment procedures to support a lower assessment of control risk.

After performing such procedures, the auditor makes an assessment of the level of control risk that the results of those procedures support. The auditor uses that assessment when determining the appropriate detection risk to accept for the related assertions.

SUPPORT FOR AN EXTENDED CONTROL RISK ASSESSMENT

37. When the auditor extends his control risk assessment for financial statement assertions beyond the understanding of the control structure, he should obtain support that the control structure policies and procedures related to a particular assertion (*a*) are suitably designed to prevent or detect and correct material misstatements in that assertion and (*b*) are operating in a manner consistent with his assessment of the level of control risk. The support that is necessary for a specific assessment of control risk is a matter of auditing judgment. Generally, however, the lower the auditor's assessment of control risk, the more support he needs that control structure policies and procedures are designed and operating effectively.

Nature of Support

38. Support for the design of policies and procedures ordinarily is obtained through one or more of the following procedures: inquiries of appropriate entity personnel, inspection of documents and reports, and observation of the application of specific policies and procedures. Support for the operation of policies and procedures generally is concerned with whether they were applied, how they were applied, and by whom they were applied. Such support ordinarily is obtained through one or more of the following procedures: inspection of documents and reports related to the policy or procedure, direct observation of the application of the policy or procedure, and reperformance of the application of the policy or procedure by the auditor.

39. The nature of the particular policies and procedures pertaining to a control structure element influences the type of support available to the auditor in considering the design or operation of those policies and procedures. For some policies and procedures, documentary support of design or operation may exist. For other elements, such support may not exist. For example, documentary support about design or operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control procedures, such as segregation of duties or controls performed by a computer. In such circumstances, the auditor may decide to obtain appropriate support through direct observation or the use of computer-assisted audit techniques to reperform the application of relevant policies and procedures.

Relationship of Support to Assertions

40. The support available for a control risk assessment is also affected by the control structure policies and procedures relevant to a financial statement assertion. For example, only the control environment may be relevant to preventing or detecting and correcting material misstatements in the valuation or allocation assertion and in the presentation and disclosure assertion for some account balances or transaction classes. For such assertions, the auditor would not need to obtain support pertaining to the accounting system or control procedures.

41. In determining the appropriate support for a conclusion about control risk, the auditor should consider that the control environment, accounting system, and control procedures may act individually or in combination to achieve or contribute to the achievement of an audit objective for a specific financial statement assertion. For example, an effective control environment may allow the auditor to conclude that control risk is limited for a specific financial statement assertion. On the other hand, an ineffective control environment may negatively affect an otherwise effective accounting system or control procedures for a particular assertion.

Timing of Obtaining Support

42. In determining the appropriate support for a conclusion about control risk, the auditor may consider the support obtained about control risk in prior examinations, as well as the nature and extent of any changes in the entity's control structure subsequent to the prior examinations. In reaching conclusions about whether changes have occurred in the control structure and about the nature and extent of such changes, the auditor ordinarily should perform one or more of the procedures discussed in paragraphs 29 and 30. Such procedures, however, may not need to be as extensive when performed in consideration of the support obtained about control risk in prior examinations.

43. When the auditor obtains support for his conclusion about control risk during interim work, he should determine what additional support is necessary for the remaining period. In making that determination, the auditor should consider the nature and extent of any changes in the entity's control structure during the remaining period, the specific control structure elements considered in obtaining support during the interim work, and the degree to which the design and operation of those elements were evaluated. In reaching conclusions about whether changes have occurred in the control structure during the interim period and about the nature and extent of such changes, the auditor ordinarily should perform one or more of the procedures discussed in paragraphs 29 and 30. Such procedures, however, may not need to be as extensive as those performed during the interim period.

44. An examination of financial statements is a cumulative process; as the auditor assesses control risk, the information obtained may cause him to modify the nature, timing, and extent of other planned control-risk-assessment procedures. In addition, information may come to the auditor's attention as a result of performing tests of financial statement balances or from other sources during the audit that differs significantly

from the information on which his planned control-risk-assessment procedures were based. For example, the extent of misstatements he detects by performing tests of financial statement balances may alter his judgment about the level of control risk. In such cases, the auditor may need to reevaluate the planned auditing procedures, based on a revised consideration of control risk for all or for some of the financial statement assertions.

CORRELATION WITH DETECTION RISK

45. The tests of financial statement balances that the auditor performs to restrict detection risk for financial statement assertions to an appropriately low level may be categorized in two general classes: *(a)* tests of details of transactions and balances and *(b)* analytical procedures applied to financial information. The auditor also may perform tests of details of transactions when assessing control risk to evaluate the degree to which specific control structure policies and procedures are operating. Although the objective of tests of details performed in tests of financial statement balances is different from the objective of such tests performed to assess control risk, both objectives may be accomplished concurrently through the performance of these tests.

46. The auditor's conclusion about control risk (together with his conclusion about inherent risk) influences the nature, timing, and extent of the tests of financial statement balances to be performed to obtain evidence to support the restriction of detection risk to an appropriately low level. When, in the auditor's judgment, the control risk (together with the inherent risk) for a specific assertion or related audit objective results in an audit risk that is appropriately low, the auditor need not apply any tests of financial statement balances to restrict detection risk for that specific assertion or related audit objective.[4] However, the auditor should consider that the control structure elements may not be relevant to some assertions or audit objectives or may not reduce audit risk to an appropriately low level. Consequently, it is unlikely that the auditor could conclude that he need not perform any tests of financial statement balances for all assertions pertaining to a significant account balance or class of transactions.

[4] The auditor should consider that some statements on auditing standards may require specific tests of financial statement balances for specific financial statement assertions. For example, see AICPA, *Professional Standards*, vol. 1, AU sec. 331, concerning confirmation of receivables and observation of inventories.

EXPOSURE DRAFT

FILE 3045

PROPOSED STATEMENT ON AUDITING STANDARDS

THE AUDITOR'S RESPONSIBILITY FOR ASSESSING CONTROL RISK

February 14, 1987
Comment date: July 15, 1987

Name and Affiliation:

Comments:

Instructions for Response Form

This perforated response form may be used for comments or suggestions relating to any aspect of the exposure draft that is of concern or interest to you. For convenience, the most significant points have been identified in the summary that accompanies this exposure draft.

TEAR ALONG DOTTED LINE

Comments (continued):